FINANCIAL POST

Pros and cons of an IPO

Jameson Berkow, Financial Post · Mar. 14, 2011 | **Last Updated: Mar. 14, 2011 8:08 AM ET**

Graduation Day is how successful former startups often reflect on the day of their initial public offering. And that analogy might be more appropriate than they realize.

Similar to students' experiences when they enter the workforce with newly conferred degrees in hand, new public companies can quickly find themselves thrust into a world of unexpected surprises.

"There is a lot more discussion around public offerings these days," said David Fabian, a partner with Toronto-based accounting and consulting firm RSM Richter. "But I don't think there is an appreciation for the primary costs associated with being public."

Mr. Fabian, who helped guide such companies as Evertz Technologies Ltd. and the Pizza Pizza Royalty Income Fund through the IPO process, notes that the initial conversion costs alone can range into the millions of dollars.

Then there are the various follow-on costs, which are seldom considered in advance. Fees charged by legal advisors, auditors and stock exchanges could add several hundred thousand dollars to a company's public tab, Mr. Fabian said.

With hot tech startups such as two-year-old online deals company Groupon Inc. or five-year-old Internet telephony provider Skype SA seemingly rushing to market, it can be difficult for rapidly growing young companies to see the forest for the trees.

Just three years old, Oakville, Ont.-based toymaker Great Circle Works Inc., managed to increase annual revenue more than 2,200% between its 2007 and 2009 fiscal years, earning it the coveted No. 1 spot in Profit Magazine's October 2010 ranking of Canada's 50 fastest growing businesses. Yet despite such spirited growth, it has no immediate plans to offer shares of the company on a public market.

"I do plan on growing the company substantially in the next few years," said Mark Cahsens, founder of Great Circle Works.

"However, with [going public] I would be concerned that the pressures from shareholders and from the marketplace would not necessarily be consistent with the right path for the company.

"Some of my attention would be pulled away from running the business," he said.

An IPO is a major disruption to a business, Mr. Fabian agrees. Yet there are several advantages associated with going public that extend well beyond the requisite funding boost.

"Going public is definitely a sign you've made it to the next level, no question about it," said Brad Cherniak, a co-founding partner at financial advisory firm Sapient Capital Partners in Toronto. "It then gives the company a currency to use to pay its employees, to pay targets of acquisitions or to create incentive programs for staff based on the stock price."

Indeed, one of the reasons Mr. Cahsens might consider taking Great Circle Works public in the future has nothing to do with the money. "I'm still a very small company, but as I grow I'm going to want to hire people who are really good at what they do in this space and being public has a draw that is more appealing to a lot of the important or experienced executives in the marketplace," he said.

Being public can energize a company, Mr. Cherniak said, "but it can also have weird effects."

Smart Technologies Inc., a Calgary based maker of digital displays for classrooms, experienced a surprising turn of events shortly after its IPO last July. A $100-million class-action lawsuit was filed against Smart Technologies last month by a group of investors who contend they purchased the stock under false pretenses. The group claims the company failed to disclose a significant decline in sales growth at a firm it had earlier acquired. Smart Technologies denies the allegations says it will "vigorously" defend itself when the Ontario Superior Court of Justice case comes to trial.

Smart Technologies isn't alone in facing such unusual problems post-IPO. "Once we became public, there were a lot of things I saw that I didn't expect," said the chief executive of a Toronto-area communications service provider who requested anonymity because the company has since re-privatized.

"All these people very quickly came out of the woodwork who service public companies, people who will go out and promote your stock and they'll want to get paid in stock as well. They'll ask for a one-year contract, then ultimately they end up doing nothing and just riding off your success and when the stock does go up on its own because of your activities or sales they get to benefit from that," the chief executive said.

"So we just found [the public market] to be a very shady world."

While such negative experiences are usually the exception and not the rule, those companies who have them can quickly find themselves in the unfortunate position of becoming a public orphan.

"That is where you end up with all of the cost and none of the benefit of being public because you can't use your shares as currency for acquisitions, your employees don't want the shares because they're going down 20% a year and you can't issue more stock because no one cares about your story or your stock price graph," Mr. Cherniak said. "Interest will dry up fundamentally and it might not be a bad company, it is just that the stock is not a good stock."

Avoiding the orphan title is easy enough. So long as patience is top of mind for companies planning on taking the plunge and they have that nice, steady hockey stick-like earnings growth curve that public markets tend to prefer, everything should work out all right.

"You need to consider your options and very carefully review the costs associated with being public before you make that leap," Mr. Fabian said. "Because once you go down that IPO road, it is very difficult to make a U-turn."

jberkow@nationalpost.com

HOW TO AVOID POST-IPO ORPHANAGE

Almost every private company that goes public in Canada risks becoming an orphan, warns Brad Cherniak of Sapient Capital Partners. To avoid suffering all the negatives of being public with none of the benefits, he recommends newly-minted public companies heed the following warning signs.

Analysts don't care about you

An ideal response from the analyst community when a company first goes public is at least one full report providing comprehensive analysis of the business. But if all the attention a company can muster is one or two people putting out basic one or twopage reports -effectively reproductions of press releases -that company might be a public orphan.

Low trading volumes

It is not uncommon for IPO orphans' shares to go days, weeks or even months without being traded. The more the share price fluctuates whenever stock does change hands, particulary if it takes a big drop, the more likely it is the company is a public orphan.

Unrealistic share price

"I've seen a fair number of companies that will have $5-million in cash on their balance sheet, yet their market capitalization is less than that cash balance," Mr. Cherniak said. "So their shares value the company as not only worthless, but as having negative value." That is an extreme example. But generally if a company makes a major announcement that has no impact on the stock, or its shares are trading far below those of comparable firms, that company might be a public orphan.

The unknown shareholder

This one might seem like a nobrainer, but many companies simply don't bother getting to know their shareholders. "Still," said Mr. Cherniak, "If you have no idea who your shareholders are, you've never met your shareholders and frankly you've just never made the rounds with institutional investors, chances are your either going to become an orphan or you're an orphan already."

Entrepreneurs who recognize one or these telltale signs in their business needn't rush to reprivatize. There are many other reasons a company might get little to no attention from analysts or have a sluggish trading frequency other than being a public orphan.

However, the more warnings that amount to accurate descriptions of a company's stock, the more likely it is.